Katten

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SEC/CORPORATE

SEC Approves Amended Rule Change to FINRA Rule 5110

On December 23, 2019, the Securities and Exchange Commission approved the Financial Industry Regulatory Authority's (FINRA) proposed amendments to Rule 5110, as modified by Partial Amendments No. 1 and No. 2 (Amended Rule 5110), on an accelerated basis in an effort to modernize, simplify and streamline the rule. FINRA is expected to issue its regulatory notice and effective date for the amended rules in the coming weeks. Rule 5110 prohibits unfair underwriting arrangements in connection with the public offering of securities. The following is a summary of key revisions made in Amended Rule 5110:

Filing Requirements

Filing Deadlines: Rule 5110 requires that members submit to FINRA documents (such as the registration statement and underwriting agreement) filed with the SEC or any state securities commission. Under the Amended Rule 5110, members will be allowed more time to make required filings with FINRA, increasing the time from one business day to three business days after filing with the SEC.

Document Filings: FINRA will require filing (1) industry-standard master forms of agreement only if specifically requested by FINRA; and (2) amendments to previously filed documents only if disclosure changes impact the underwriting terms and arrangements for the public offering in such documents.

Amended Rule 5110 also makes a number of clarifications regarding filing requirements including: (1) a member participating in an offering is not required to make a FINRA filing, if a filing has already been made by another member participating in the offering; (2) any public offering in which a member participates must now be filed for FINRA's review unless exempted; (3) no member may engage in the distribution or sale of securities unless FINRA has first provided an opinion that it has no objection to the proposed underwriting terms and arrangements; and (4) any member acting as a managing underwriter or in a similar capacity must notify other members participating in the public offering, if FINRA provides an opinion that the underwriting terms and arrangements are unfair and unreasonable, and the proposed terms and arrangements have not been appropriately modified.

Shelf Offerings:

Amended Rule 5110 now codifies exemptions from filing requirements for certain shelf offerings that have historically been exempt and streamlines filing requirements for remaining shelf offerings.

Public Offerings Exempt from Substantive and/or Filing Requirement

Amended Rule 5110 exempts from its filings requirements any public offering conducted by an "experienced issuer" (i.e., an issuer with a 36-month reporting history and with at least $150 million aggregate market value of voting stock held by non-affiliates or, alternatively, at least $100 million aggregate market value of voting stock held by non-affiliates and an annual trading volume of voting stock of at least three million shares). For shelf offerings by issuers that do not meet the "experienced issuer" standard, the filing obligations are limited to: (1) the Securities Act of 1933 registration statement number; and (2) certain limited documents only if specifically requested by FINRA. Also exempt from filing requirements and substantive provisions of Rule 5110 are: (1) public offerings of closed-end "tender offer" funds; (2) insurance contracts; (3) unit investment trusts; and (4) tender offers by issuers for their own securities made pursuant to Rule 13e-4 under the Securities Exchange Act of 1934.

Disclosure Requirements of Underwriting Compensation

Amended Rule 5110 makes the existing practice of disclosing specified material terms and arrangements related to underwriting compensation in the prospectus an explicit requirement and requires a description of: (1) any right of first refusal and its duration granted to a participating member; and (2) any additional material terms and arrangements of securities obtained by the participating member, including exercise terms, demand and piggyback registration rights, and lock-up periods.

Underwriting Compensation

“Underwriting compensation” has now been defined to mean “any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering.” It includes finder’s fees, underwriter’s counsel fees and securities. Rule 5110 currently provides that all items of value received or to be received from any source are presumed to be underwriting compensation when received during the period commencing 180 days before the required filing date of the registration statement and ending up to 90 days following the effectiveness or commencement of sales of a public offering. Amended Rule 5110 introduces the defined term “review period” and provides that the applicable time period would vary based on the type of offering but would typically include the 180-day period preceding the required filing date through the 60-day period following the final closing of the offering.

Amended Rule 5110 has added several new examples of what will not constitute underwriting compensation, including: (1) advisory services in connection with some corporate reorganizations and payments for records management; (2) legal payments or reimbursement resulting from an issuer’s contractual breach or misrepresentation; (3) securities acquired pursuant to a governmental or court approved proceeding or plan of reorganization as a result of action by the government or court (such as in a bankruptcy or tax court proceeding); (4) non-convertible securities purchased by the participating member in a public offering at the public offering price during the review period; (5) certain accountable expenses; and (6) compensation received through an employee benefit plan that qualifies under Section 401 of the Internal Revenue Code or a similar plan.

FINRA will also take a principles-based approach in considering whether issuer securities received from third parties or in directed sales programs may be excluded from underwriting compensation.

Venture Capital Exceptions

Venture capital exceptions have been expanded by no longer treating as underwriting compensation securities acquisitions and conversions to prevent dilution and securities purchases based on a prior investment history occurring before the review period. When subsequent securities acquisitions take place (e.g., pursuant to a stock split, a right of preemption or a securities conversion, or when additional securities are acquired to prevent dilution of a long-standing interest in the issuer), the acquisition of such additional securities would not be treated as underwriting compensation. FINRA also broadened two of the current venture capital exceptions and adopted a new venture capital exception for highly regulated entities with significant disclosure requirements.

Treatment of Non-Convertible or Non-Exchangeable Debt Securities and Derivatives

Amended Rule 5110 clarifies that the following will not constitute underwriting compensation: (1) non-convertible or non-exchangeable debt securities and derivative instruments acquired in a transaction unrelated to a public offering; (2) securities acquired by a member firm acting as a bona fide market maker; and (3) purchases of both convertible and non-convertible securities during the review period by a participating member in a public offering at the public offering price and on the same terms as all others that are not participating members.

Lock-Up Restrictions:

Amended Rule 5110 provides that the lock-up period of 180 days on securities considered underwriting compensation will begin on the date of commencement of sales of the public equity offering, rather than the date of effectiveness of the prospectus. Exemptions from the lock-up restriction have been added for (1) securities acquired from an issuer that meets the registration requirements of SEC Registration Form S-3, F-3 or F-10; (2)

securities acquired in a transaction meeting one of Rule 5110's venture capital exceptions; (3) securities acquired as underwriting compensation that are registered and sold as part of a firm commitment offering; (4) derivative instruments acquired at a fair price in connection with a hedging transaction related to the public offering; (5) securities that are "actively-traded" (as defined in Rule 101(c)(1) of SEC Regulation M); and (6) the transfer or sale of securities back to the issuer in a transaction exempt from registration with the SEC.

Other Changes:

Amended Rule 5110 clarifies the list of prohibited unreasonable terms and arrangements in connection with a public offering of securities, adds new defined terms and makes certain organizational changes to Rule 5110.

The full text of the SEC Order with Amended Rule 5110 is available here.

SEC Announces Proposed Amendments to Modernize Auditor Independence Rules

On December 30, 2019, the Securities and Exchange Commission voted to propose amendments (the Proposal) to its auditor independence rules, many of which have not been updated since their initial adoption in 2000 and amendments in 2003. The Proposal, if adopted, would codify certain SEC staff consultations and modify certain aspects of the auditor independence framework set forth in Rule 2-01 of Regulation S-X (Rule 2-01), which, among other things, requires auditors to be independent of their audit clients "both in fact and in appearance." Specifically, Rule 2-01(b) sets forth the general standard for auditor independence, while Rule 2-01(c) provides an illustrative list of relationships and circumstances in which an accountant would not be considered independent, including certain financial, employment, business and other relationships between the auditor and the audit client. In the SEC's press release announcing the Proposal, SEC Chairman Jay Clayton noted that, "The proposed amendments are based on years of Commission staff experience in applying our auditor independence rule set and respond to recent and longer term feedback received from a wide range of market participants," and, further, that the proposed amendments would "increase the number of qualified audit firms an issuer could choose from and permit audit committees and Commission staff to better focus on relationships that could impair an auditor's objectivity and impartiality." As highlighted in the fact sheet included in the press release, if adopted, the Proposal would, among other things:

(1) amend the definition of "audit client" in Rule 2-01(f)(6), which generally includes each "affiliate of the audit client" (as such term is defined in Rule 2-01(f)(4) and includes entities "under common control with the audit client" that are sometimes referred to as "sister entities") to include a materiality qualifier, which would give the auditor discretion to determine whether a company under common control with the audit client is material to the controlling entity. The SEC noted in the Proposal, however, that the auditor independence analysis may not be concluded based solely upon a determination that a sister entity is not material to the controlling entity because "auditors and audit clients must consider 'all relevant facts and circumstances' when assessing independence pursuant to the general standard in Rule 2-01(b)";

(2) amend the definition of the "audit and professional engagement period" in Rule 2-01(f)(5)(iii) to shorten the look-back period during which domestic first-time filers must assess and ensure their auditor's independence from three years to one year (i.e., the immediately preceding fiscal year);

(3) add certain student loans and de minimis consumer loans to the categorical exclusions from independence-impairing lending relationships set forth in Rule 2-01(c);

(4) amend the business relationship rule in Rule 2-01(c)(3) (which prohibits the accounting firm or any covered person from, at any point during the audit and professional engagement period, "having any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity," including, among others, substantial stockholders of an audit client) to replace the reference to "substantial stockholders" with the concept of "beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client"; and

(5) replace the transition and grandfathering provision in Rule 2-01(e) with a transition framework to address inadvertent independence violations that only arise as a result of a "corporate event," such as a merger or acquisition transaction, which new framework would provide that the auditor's independence is not impaired so long as (1) the services or relationships that would otherwise be the basis for the violation were not prohibited prior to the consummation of the corporate event, (2) the auditor corrects the independence violations arising from

the corporate event as promptly as possible and, in any event, no later than six months following the closing of the corporate event; and (3) the auditor has a quality control system to monitor the audit client's corporate events and related activities to promptly identify any potential independence violations before the closing of the corporate event.

The SEC is soliciting comments on the Proposal for a period of 60 days after publication in the Federal Register.

The full text of the Proposal is available here, and the press release and fact sheet are available here.

SEC Issues Guidance on Confidential Treatment Applications and Intellectual Property and Technology Risks

In December 2019, the staff of the Division of Corporation Finance of the Securities and Exchange Commission issued interpretive guidance on (1) confidential treatment applications and (2) intellectual property and technology risks that may occur when companies engage in international operations.

The guidance is available here and here.

BROKER-DEALER

SEC Approved Amendments to FINRA's New Issue Rules

The Securities and Exchange Commission (SEC) has approved amendments to Financial Industry Regulatory Authority (FINRA) Rules 5130 and 5131, which govern the offer and sale of "new issue" securities. The amendments went into effect on January 1. Please refer to Katten's Financial Markets and Funds Advisory for more information.

FINRA Requests Comments on Rule 4530 Reporting Requirements

The Financial Industry Regulatory Authority (FINRA) is requesting comment on whether to make changes to FINRA Rule 4530, which requires member firms to report specified events, internal conclusions of violations and customer complaint information to FINRA. Among other things, FINRA is seeking input on whether the rule effectively addresses its original purposes in light of regulatory, technological or other environmental changes.

FINRA periodically conducts a retrospective review of the efficacy of significant rulemakings, and FINRA is soliciting comments on Rule 4530 in connection with such a review. The comment period ends on March 9.

FINRA Regulatory Notice 20-02 is available here.

FINANCIAL MARKETS

See "FCA Releases Asset Management Portfolio Tools Feedback" in the EU Developments section.

CFTC

CFTC Announces Members of New "Margin Subcommittee"

On January 10, Commodity Futures Trading Commission Commissioner Dawn D. Stump, the sponsor of the CFTC's Global Markets Advisory Committee (GMAC), announced the members of the newly-established Subcommittee on Margin Requirements for Non-Cleared Swaps (the Margin Subcommittee). The Margin Subcommittee will consider issues raised by the implementation of margin requirements for non-cleared swaps, identify challenges associated with forthcoming implementation phases and make recommendations via a report for the GMAC to consider in advising the CFTC.

The Margin Subcommittee will be chaired by Wendy Yun, co-chair of the Derivatives Committee of the Securities

Industry and Financial Markets Association Asset Management Group. The full list of the Margin Subcommittee members is available here.

BANKING

OCC and FDIC Release Proposed Revisions to Community Reinvestment Act

On January 9, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) (together known as the Banking Agencies) published proposed rules in the Federal Register that are designed to make the regulatory framework related to the Community Reinvestment Act (CRA) more “objective, transparent, consistent, and easy to understand” (Proposal). The last major revisions to the CRA were made in 1995.

The Banking Agencies’ goals in connection with the issuance of the Proposal are wide-ranging but include reducing CRA deserts, reducing activity uncertainty, increasing small business and small farm lending and encouraging long-term commitment to community reinvestment.

To accomplish these goals, the Proposal focuses on four key areas: (1) clarifying and expanding what qualifies for CRA credit to encourage banks to more readily engage in innovative projects that have positive impacts on communities; (2) expanding where CRA activity counts through the creation of “deposit-based” assessment areas, where banks have a significant amount of retail deposits; (3) providing an objective method to measure CRA activity based upon a bank’s size; and (4) revising data collection, recordkeeping and reporting that would have various benefits, including timelier and more efficient CRA evaluations.

More information is available here.

Comments are due on or before March 9.

UK DEVELOPMENTS

See “FCA Releases Asset Management Portfolio Tools Feedback” in the EU Developments section.

EU DEVELOPMENTS

FCA Releases Asset Management Portfolio Tools Feedback

On January 13, the UK Financial Conduct Authority (FCA) released the findings of their multi-firm review of how asset management firms select, use and oversee the tools and models they use to manage portfolios (the Review).

The Review is a follow-up to, among other things, the Technology and Cyber Resilience Questionnaire, the results of which were published in November 2018 and are available here. The FCA's concerns about operational resilience were exemplified in the TSB IT failure in April 2018, in which 1.9 million customers were unable to access their online accounts for up to a week. Operational resilience is a key cross-sector priority for the FCA, as set out in the 2019/20 Business Plan.

In the Review, the FCA visited ten firms in the asset management sector and met with senior executives from the first and second lines of defense to see how they selected and used risk modelling and other portfolio management tools. They observed three general approaches:

- firms using an "integrated package" from a single provider
- firms using "a suite of tools from different providers," and
- firms who build their technology in-house.

Firms who use a single provider observed that, while this approach tended to be less complex and more reliable due to consistent data handling, the potential drawbacks included concentration risk and resilience implications.

Firms also felt that once they had chosen a single provider it would be very difficult to move to other providers.

By comparison, firms who developed their tools in-house found that it gave them greater flexibility and capacity to be distinctive but also that it was more expensive. Firms with in-house tools actively considered licensing their software to competitors.

The FCA also asked about different approaches to vendor management, model governance, change management, software testing, resilience and recovery, and customer expectations. In particular, with regard to resilience and recovery, the FCA observed that firms had "not given enough consideration" to how they would manage outages, especially if the outage were to last a long time or happen frequently.

The FCA expects other asset management firms to look at their operational resilience arrangements to ensure that they can comply with the Handbook and meet their regulatory obligations.

The findings are available here.

For additional coverage on financial and regulatory news, visit *Bridging the Week*, authored by Katten's Gary DeWaal.

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